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Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
as successor to The Herald Company,
Petitioner,

—v.—

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF AMICUS CURIAE OF COOPERS & LYBRAND

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STATEMENT OF INTEREST

Coopers & Lybrand ("C&L") is a national auditing, tax consulting, actuarial and management consulting firm with 16,500 partners and employees in 98 cities throughout the United States, and with affiliated firms in over 120 countries throughout the world.

C&L provides a variety of financial and tax advisory services to thousands of business and individual clients. An important segment of its services deals with advising clients, auditing and expressing opinions on proper accounting for purchases of going businesses for both tax and financial

reporting purposes. The scope of its services includes valuations of assets (especially intangibles), allocations of purchase price and determination of appropriate depreciation and amortization periods. Approximately 10 partners and 100 other professionals are principally involved in its valuation practice, with hundreds of additional tax and accounting partners and professionals advising clients on these matters from time to time.

The instant case is of major interest to C&L as it frequently deals with goodwill, going concern value, and identifiable income-producing intangible assets in its auditing, tax and valuation practices.

SUMMARY OF ARGUMENT

The major issue before this Court is whether (a) subscriber relationships purchased as part of an on-going newspaper business, which have been identified, separately valued and which have a limited useful life are, therefore, amortizable; or, (b) as the value of such subscriber relationships is based on the income to be derived from these relationships, they are inextricably linked to nondepreciable goodwill simply because among the variety of definitions of goodwill that have evolved is one that is based upon the expectancy of continued patronage.

Undoubtedly, many of the legal and other aspects surrounding this issue will be addressed by respective counsel for Petitioner and Respondent and in the many amicus curiae briefs that can be expected.

Accordingly, this brief is devoted to certain accounting and asset valuation aspects of the instant case which, while relatively narrow in the context of the entire case, are of sufficient importance in C&L's view to bring to the attention of this Court. The principal points are summarized as follows:

ACCOUNTING ASPECTS

- In order to avoid distortion of net income by properly matching expenses to income, generally accepted accounting principles have always required the assignment of values to specifically *identifiable* intangible assets (including customer based intangible assets) acquired in a business combination accounted for as a purchase, where the value and the lives are determinable. Such assigned value must then be amortized over the period expected to be benefited by use of the asset (*i.e.*, the useful life).
- For purchases initiated after October 31, 1970, generally accepted accounting principles require that the value assigned to *unidentifiable* intangible assets (the excess of purchase price over the fair market value of identifiable assets, commonly referred to as "goodwill") be amortized over a period not to exceed 40 years.

ASSET VALUATION ASPECTS

- The valuation of the subscriber relationships under the income method, and without regard to the unreliable replacement cost valuation offered by the government, was proper under the facts and circumstances of the instant case.
- Contrary to the government's suggestion, not all customer-based intangible assets are capable of separate valuation and possess a determinable useful life—the requirements for depreciation under tax and accounting principles.

I.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES RELATED TO INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION REQUIRE ASSIGNMENT OF SEPARATE VALUES TO IDENTIFIABLE CUSTOMER RELATIONSHIPS WITH DETERMINABLE LIVES AND AMORTIZATION OVER SUCH LIVES.

A. The Authoritative Literature is clear on the basic rules.

Generally Accepted Accounting Principles ("GAAP") is a term recognized by preparers, auditors, and users of financial statements to encompass rules, conventions and procedures that define accepted accounting practice. This has resulted in a GAAP hierarchy with the pronouncements of certain designated standard setters being recognized as the "highest level." Since 1973, the highest level standard setter has been the Financial Accounting Standards Board ("FASB"), the successor to the Accounting Principles Board ("APB") of the American Institute of Certified Public Accountants ("AICPA") (1962-1973) and the Committee on Accounting Procedure of the AICPA prior to 1962. Pronouncements of one of these standard setters remain at the highest level of the GAAP hierarchy unless superseded or amended by a successor.

APB Opinion No. 16, *Business Combinations*, ("Opinion No. 16") establishes GAAP for business combinations (both poolings of interests and purchases) initiated after October 31, 1970. A pooling of interests is an accounting practice where the acquired company's recorded amounts for assets and liabilities are carried forward after the combination. It is required when certain specified criteria are met covering (1) attributes of the combining companies, (2) the manner of combining the interests of the companies and (3) the absence of certain planned transactions. All other business combinations must be accounted for as purchases. This involves the allocation of the purchase price (value of consideration given and liabilities assumed) to the assets acquired. The discussion

herein relates solely to the accounting for a business combination required to be accounted for as a purchase.

Paragraph 88(e) of Opinion No. 16 which provides specific guidance for assigning amounts to intangible assets, states: "Intangible assets which can be identified and named, including contracts, patents, franchises, *customer and supplier lists*, and favorable leases, [should be recorded] at appraised values" (emphasis added). Footnote 12 to paragraph 88(e) states: "Fair values should be ascribed to specific assets; identifiable assets should not be included in goodwill." Goodwill is the residual after the assignment of values to all other assets and liabilities acquired.

APB Opinion No. 17, *Intangible Assets* ("Opinion No. 17"), establishes GAAP for amortizing both identifiable and unidentifiable intangible assets acquired in a business combination accounted for as a purchase. Paragraph 26 of that Opinion states:

> "Intangible assets acquired as part of a group of assets or as part of an acquired company should also be recorded at cost at date of acquisition. Cost is measured differently for specifically identifiable intangible assets and those lacking specific identification. The cost of identifiable intangible assets is an assigned part of the total cost of the group of assets or enterprise acquired, normally based on the fair values of the individual assets. . . . Cost should be assigned to all specifically identifiable intangible assets; cost of identifiable assets should not be included in goodwill."

Paragraph 27 of Opinion No. 17 identifies several factors that should be considered in estimating the useful lives of intangible assets over which amortization *must* be recorded because, "The Board believes that the value of intangible assets . . . eventually disappears and that the recorded cost . . . should be amortized by systematic charges to income over the periods estimated to be benefited." Paragraph 29 of Opinion No. 17 establishes a maximum period of amortization of 40 years. Thus, current GAAP for business combina-

tions requires that *all* intangible assets, including goodwill, be amortized over their reasonably estimated useful life (not to exceed 40 years).

The conclusion to amortize all intangibles is described in paragraph 23 of Opinion No. 17 as "a practical solution." That paragraph states, "This accounting follows from the observation that few, if any, intangible assets last forever. . . . Allocating the cost of goodwill or other intangible assets with an indeterminate life over time is necessary because the value *almost inevitably becomes zero at some future date*" (emphasis added). The "practical solution" related to the need to change prior practice and to address the views of many theoreticians regarding the accounting for *unidentifiable* intangibles with an indeterminate life (*e.g.*, goodwill) because it had long been the practice in accounting for purchase business combinations that *identifiable* intangibles with a limited life be separately identified and amortized over that life.

Prior to being superseded by Opinion Nos. 16 and 17, the highest level of GAAP on accounting for intangible assets was found in Accounting Research Bulletins ("ARBs") published by the Committee on Accounting Procedure. ARB No. 24, *Accounting for Intangible Assets*, classified intangibles into type (a) and type (b) intangibles. Type (a) intangibles were described as "Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration)." The ARB required the cost of type (a) intangibles to be amortized by systematic charges in the income statement over the period benefited.

Type (b) intangibles were described as "Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises and organization costs)." Generally, ARB No. 24 permitted carrying a type (b)

intangible at cost until it became reasonably evident that the term of existence had become limited. At that time, it would be considered a type (a) intangible and amortization would commence over that life. The ARB also permitted amortization of a type (b) intangible when a company decided the intangible may not have a life over the entire existence of the company, but the life was not yet limited as in the case of a type (a) intangible. ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 5, "Intangible Assets," retained essentially intact the provisions of ARB No. 24.

In summary, the accounting literature, at the highest level in the GAAP hierarchy, has always required assignment of values to specifically *identifiable* intangibles acquired in a business combination accounted for as a purchase, and amortization over the estimated period to be benefited (*i.e.*, their useful life). Opinion No. 17 also requires amortization of *unidentifiable* intangible assets over a period not to exceed 40 years.

B. Determination of Useful Lives of customer relationships involves the exercise of judgment, but the theory that the lives are indefinite because they constantly renew and grow was rejected by the FASB.

While GAAP requires the identification and amortization of specifically identifiable intangibles, there is considerable judgment required in determining their useful lives. For many identifiable intangibles the lives are fixed by a statute or regulation (*e.g.*, a patent or copyright) or by a contractual provision (*e.g.*, a favorable lease). In other cases, the useful lives must be determined by reference to other factors. A customer list, it is sometimes argued, constantly renews and grows; therefore, its life may be considered indefinite. (Opinion No. 16 names a customer list as a specifically identifiable intangible, clearly establishing the APB's intent for specific identification, but judgment is still required in establishing a proper life.) However, the theory of constant renewal to justify an indefinite life for a specifically identifiable intangible was

rejected by the FASB in Statement of Financial Accounting Standards No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, which states in paragraph 41:

> "The Board disagrees with those respondents who stated that intangible assets attributed to deposit accounts and customer relationships generally have indefinite lives. Those respondents viewed such relationships as being constantly renewed and growing and, therefore, indicated that a 40 year useful life may often be appropriate. [This statement recognized that APB Opinion No. 17 had already established a maximum life for GAAP.] The Board notes that Interpretation 9 [FASB Interpretation No. 9, *Applying APB Opinion Nos. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*] refers to intangible factors representing the capacity of *existing* accounts to generate future income or new business. The Board recognizes that many enterprises purchase a banking or thrift institution with the expectation of maintaining and even expanding the existing customer base and, thereby, the value of the related intangible asset; however, only purchased intangible assets are capitalizable under present generally accepted accounting principles. The Board believes that the cost and useful life of acquired intangible assets should not reflect the cost and expectations of developing, maintaining, or restoring such intangibles after they are acquired."

Thus, the FASB has refuted the constant renewal theory as an argument for an indeterminate life. The ability to maintain and/or grow the asset should *not* be a factor when evaluating the life of an acquired intangible.

A review of disclosures in the annual reports of public companies reveals that many have allocated a value to a customer list acquired in a business combination. Selected examples are attached as an Appendix to this Brief. In those instances when a short life is assigned to a customer list, the

customer appears to be a specifically identifiable end user/consumer. Examples include subscribers to publications, clients of employment agencies, and homeowner/business users of specific services. Companies whose products are sold generally through distribution networks, where demand for products (and the ultimate value of the "customer" that was acquired) is determined by an unidentifiable end user/consumer, such as the newsstand purchasers in the instant case, often do not assign an amount or a shorter life to a customer list. In the latter cases, valuation of the "list" and determination of a life are, arguably, inseparable from other unidentifiable intangibles.

II.

THE INCOME METHOD OF VALUATION IS THE MOST APPROPRIATE METHOD TO VALUE CUSTOMER-BASED INTANGIBLE ASSETS.

Typically, when a going business is acquired, the purchase price is set based upon the expected net income productivity of the target enterprise's asset base.

Notwithstanding the expected net income focus in arriving at the overall purchase price, the tax laws and accounting rules require that the underlying categories of acquired assets be valued individually. This must be done in order to determine their adjusted cost bases so that there can be a proper matching of income and expense, including computations of gains and losses on dispositions, deductions for write-offs and write-downs, and deductions for depreciation and amortization.

It can be readily seen that, in the context of the acquisition of an on-going business, the tax laws and accounting rules necessarily impose a scenario where the seller and buyer implicitly negotiate a price for each asset. All relevant facts and circumstances must be taken into account.

The obvious starting point in determining the fair market value of a particular asset is to ascertain the price at which

an identical or sufficiently comparable asset could have been acquired in an accessible market. If reliable market data is unavailable, however, two questions must be answered:

1. What would be the cost of reconstructing a sufficiently comparable asset?

2. In the case of an income-producing intangible asset, what is the properly capitalized value of the asset in view of the stream of net income it can be reasonably expected to generate?

It is important to note that *both* questions must be asked and, *if possible*, both must be answered. If proper values can be adequately demonstrated under *both* the replacement cost and income methods, the lower value must prevail. If, on the other hand, an asset can be satisfactorily valued under only one of these two methods, that method—and that method alone—is sufficient to establish the asset's value. That value is not affected simply because a different amount is calculated under another *inadequate* method. *Buffalo Tool & Die Mfg. Co., v. Commissioner*, 74 T.C. 441, 452 (1980); 42 T.C.M. 841.

An income method is frequently used to value assets in the absence of market valuation data, especially intangible assets having a close nexus to income production. The income method is theoretically sound because it is bottomed on the same factors used to arrive at the overall purchase price for the business, *i.e.*, income flow. It is noteworthy that the *IRS Valuation Guide for Income, Estate and Gift Taxes* explicitly states that, "the actual or prospective income factor takes precedence over any other factor in valuing intangibles" (p. 13, 102-105). Indeed, in the instant case, the income method was optimal since the subscriber relationships were easily identifiable, and the tenure of their relationships along with expected revenues and offsetting costs were capable of projection with reasonable certainty. In contrast, as the district court found, there was insufficient data to apply a replacement cost method.

III.

NOT EVERY CUSTOMER-BASED INTANGIBLE CAN BE ASCRIBED A USEFUL LIFE AND VALUE BY AN EXPERT

Contrary to the government's suggestion, not every customer-based intangible can be ascribed a useful life and value by an expert.

In order to depreciate an intangible asset it must (i) be identifiable; (ii) be capable of valuation; and, (iii) possess a determinable life. In many situations, however, one or more of these requirements for depreciation will either be absent or not factually supportable by the taxpayer. For example, customer relationships arising from newsstand sales *cannot* be specifically identified. In C&L's experience, customers were identified but their purchases were too sporadic and unpredictable to reasonably ascertain either the duration of the relationships or the value of the relationships (based on their net income stream). In other instances, customers were identifiable and their purchases were regular and predictable, but the future loss of such customers was not reasonably predictable (based upon objective evidence) and, therefore, the customer relationships did not have determinable lives. In all such circumstances, the assets are not depreciable.

Respectfully submitted,

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APPENDIX

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Following are examples of public companies that disclose in their annual reports ("ARs") the allocation of purchase price to acquired customer lists or similar intangibles and disclose an amortization period for such intangibles that is shorter than 40 years:

- AKORN INC.; 6/30/90 AR: "The excess of the purchase price over the net assets acquired was allocated to certain intangible assets (primarily customer lists) and is being amortized using the straight-line method over five years."
- BROWNING FERRIS INDUSTRIES INC.; 9/30/90 AR: "The cost over fair value of net tangible assets of acquired businesses is amortized on the straight-line method over periods not exceeding 40 years. Other intangible assets, substantially all of which are customer lists and covenants not to compete, are amortized on the straight-line method over their estimated lives, typically no more than seven years."
- CHARLES SCHWAB, CORPORATION (THE); 12/31/90 AR: "Customer lists are amortized on a straight-line basis over periods from four to fifteen years."
- CHESAPEAKE UTILITIES CORPORATION; 12/31/90 AR: "Intangible assets include . . . goodwill, customer lists . . . associated with the acquisition of non-utility companies, and are being amortized on a straight-line basis. . . . Customer lists . . . 12 years."
- COM SYSTEMS INC. 12/31/89 AR: "As part of the acquisition, the Company recorded customer acquisition costs of $1,368,000 which are being amortized over a four year period. . . . Customer acquisition costs and excess cost over net tangible assets acquired are amortized on a straight-line basis over their esti-

mated useful lives of four years and twenty-five years, respectively."

- DEP CORPORATION; 7/31/86 AR: "The total cost of the acquisition was $4,381,000. . . . Of this amount, $300,000 was allocated to the acquisition of the Natures Family customer list and is being amortized over 5 years. The remainder of the excess of cost over assets acquired, $2,343,000, is being amortized over forty years."

- DIVERSIFIED HUMAN RESOURCES GROUP INC.; 12/31/89 AR: "Intangible assets are amortized on the straight-line method over their estimated useful lives which range from three to ten years (see Notes 3 and 4)." Note 4 identifies customer lists as one of the intangible assets.

- FIRST CHICAGO CORPORATION; 12/31/90 AR: "Goodwill, representing the cost of investments in subsidiaries and affiliated companies in excess of the fair value of net assets acquired, is amortized on a straight-line basis over periods ranging from 10 to 25 years. . . . Other intangible assets, such as the value of acquired customer lists . . . are amortized using various methods over the periods benefited, ranging from 3 to 17 years."

- FLORIDA EMPLOYERS INSURANCE COMPANY (THE); 12/31/89 AR: "Included in the assets purchased were the customer lists and expiration records which disclose when policies issued by Walton are scheduled to expire. These "Expirations" are considered proprietary and $728,800 of the initial acquisition cost has been allocated to this intangible asset. . . . The value assigned to the customer list and expiration records acquired with the purchase of the assets of Walton Insurance Services, Inc. is being amortized over a ten year period, based upon the expected attrition rate of the acquired book of business."

- LIN BROADCASTING CORPORATION; 12/31/89 AR: "This acquisition will be accounted for using the purchase accounting method. . . . Amounts allocated to customer lists will be amortized over seven years and amounts allocated to licenses and goodwill will be amortized over forty years."

- NATIONAL HEALTH LABORATORIES INCORPORATED; 12/31/90 AR: "Intangibles, consisting of goodwill and other intangibles (i.e., customer lists and non-compete agreements), are being amortized on a straight-line basis over a period of 40 years and 25 years, respectively."

- PARK COMMUNICATIONS INC.; 12/31/90 AR: "Intangible assets are stated at cost and consist of subscription lists, advertising contracts . . . and excess of cost over net assets acquired. Intangible assets other than excess of cost over net assets acquired, are being amortized by the straight-line method over estimated lives ranging primarily from 7 to 20 years. . . . Excess of cost incurred since October 31, 1970 is being amortized by the straight-line method over a period of 40 years."

- PIONEER HI-BRED INTERNATIONAL INC.; 8/31/89 AR: "Intangible assets, primarily goodwill and customer lists, are stated at amortized cost and are being amortized by the straight-line method over four to ten year periods."

- PRONET INC.; 12/31/90 AR: "Other assets include goodwill and customers lists, patents and software purchased for internal use which are being amortized straight-line over five to ten-year periods."

- READICARE, INC.; 2/28/86 AR: "Acquired intangible assets consist primarily of patient records, customer lists . . . and the excess of cost over acquired net assets in conjunction with various acquisitions. Such assets are amortized using the straight-line

method over their estimated useful lives, ranging from 3 to 40 years."

- SHAKLEE CORPORATION; 12/31/88 AR: "Intangible assets, which are related to acquisitions of businesses, primarily consist of customer mailing lists, patents and trademarks and are being amortized using the straight-line method over their estimated lives ranging from 5 to 40 years."
- SIERRA SPRING WATER COMPANY; 12/31/86 AR: "Purchased customer lists are amortized using the straight-line method over periods of 10 to 15 years representing the estimated term of service to established customers in the respective service areas. . . . Goodwill represents costs in excess of net assets of businesses acquired and is being amortized using the straight-line method over 40 years."
- STAFF BUILDERS INC.; 2/28/91 AR: "Intangible assets also include customer lists, trademarks and non-compete agreements, which are generally amortized over a three to eight year period on a straight-line basis."
- THACKERAY CORPORATION; 12/31/89 AR: "Among the assets acquired are the following intangible assets, each of which is being amortized using the straight-line method. . . . Customer list . . . 10 years."
- TUSCARORA PLASTICS INC.; 8/31/90 AR: "Of the purchase price, $1,400,000 was allocated to the machinery and equipment and $350,000 to the value of customer lists. . . . The $350,000 is included in other assets and is being amortized over five years."
- UNIFIRST CORPORATION; 8/25/90 AR: "Customer lists are amortized over a seven to sixteen year period. Goodwill is amortized over periods of up to forty years."

- UNIFORCE TEMPORARY PERSONNEL INC.; 12/31/90 AR: "On July 25, 1988, the Company acquired certain assets including licensing and franchise agreements, customer lists . . . and other intangible assets of Employers Overload (EO), a temporary services company. . . . The acquisition was accounted for using the purchase method of accounting. . . . The purchase price has been allocated to the various assets purchased and is being amortized over a five-year period which approximates their expected useful lives."
- WAVERLY PRESS INC.; 12/31/87 AR: "Intangible assets, including subscription lists and publication rights, are carried at their assigned cost at acquisition date, less accumulated amortization of. . . . Such costs are amortized on a straight-line basis over the expected life of the publications, not to exceed a period of 10 years."